Russia

THE LOCAL BID

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Financial deepening is an important long-term driver of improved risk adjusted investment returns in EM. This note presents the increasingly compelling Russian financial deepening story in five exhibits.

Key judgments

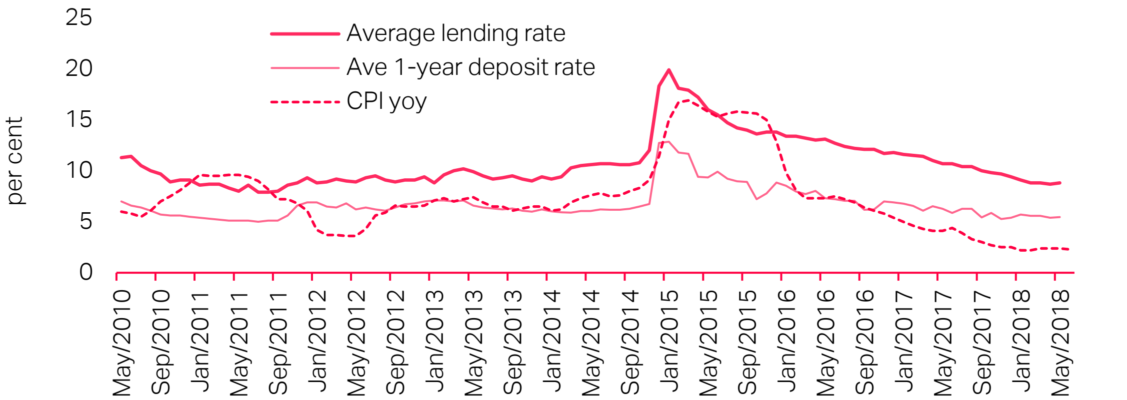
- Monetary policy underpins the recent advances and brightening prospects of financial deepening in Russia, but fiscal policy is also contributing to the strengthening local bid that speeds recovery from periodic market turbulence.
- The aftermath of the latest sanctions scare this month will show this live benefit of financial deepening in action once again.
- More profound benefits will be felt in the longer term thanks to the policy-driven mobilization of both individual and public savings channelled into the domestic capital market.
- Geopolitical risk paradoxically boosts the capital flight reversal and de-dollarization that are important facets of the financial deepening story.
- An imminent and decisive breakthrough is the launch of a new pension investment system – reducing the fixed income risk premium and particularly benefitting the equity market, including via improved corporate governance incentives.

A deep catch-up story

Financial deepening is a standard feature of emerging market success stories. As countries' financial systems develop, larger portions of their expanding savings are intermediated through a widening range of increasingly long-term financial instruments. The ultimate beneficial effect – other things being equal – is higher potential growth rates complemented by lower volatility of output. The more immediate gain, however, is particularly relevant to financial investors. This benefit stems mainly from the heavier ballast of domestic collective investment and savings schemes – above all pensions and insurance – in countries' financial markets, and its most pleasing symptom is less volatile asset prices.

In addition to financial deepening in the standard sense, various related factors can contribute to this positive outcome. These other factors range from reduced capital flight and the de-dollarization of the financial system to the stabilization of the exchange rate (nominal and real). The common underlying theme is a more domesticated and self-reliant market, less exposed to fickle cross border flows. More than two decades on from the very adverse starting conditions of post-Soviet collapse, Russia is now looking like catching up with the more financially advanced EM countries in this important area.

The move to stably positive real rates



Source: CBR

The basic pre-condition for a financial deepening breakthrough is orthodox and credible monetary policy. Russia is no exception here, with the key 'ingredient' being interest rates – including retail deposit returns – kept in positive territory since the central bank (CBR) shifted to a fully-fledged inflation targeting regime in 2014. As shown in the chart above, the weighted average 1-year retail deposit rate had fallen by last April to 5.46% on the back of steady monetary easing, but remains comfortably higher than actual (and prospective) inflation.

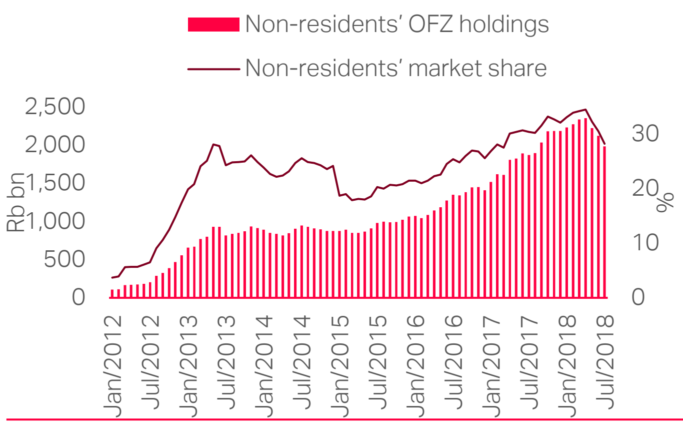
A less conventional aspect of this Russian financial deepening case may be the way that fiscal policy enhancements are decisively complementing that monetary foundation. This effect stems from the most distinctive feature of the Russian macroeconomic policy mix: the FX market interventions under the new fiscal rule. Using 'excess' oil tax revenues to fund FX purchases on the domestic market has produced a cushion of domestic liquidity (while avoiding any inflationary side effects thanks to adequate sterilization).

Exhibit #1: OFZ market shock cushioned

This fiscal rule driver underlies the first of our six exhibits that tell this story of Russia's financial system and capital market becoming more self-reliant. The episode in question is last April's US sanctions 'bazooka', showing the greater robustness of the Russian market to such external shocks. In Q2, non-residents sold about US$6 billion-worth of their OFZ holdings (more than reversing a US$4 billion foreign inflow into OFZs during Q1). As a result, the non-resident share of the OFZ market fell to its lowest point since March 2017 (see left-hand chart below).

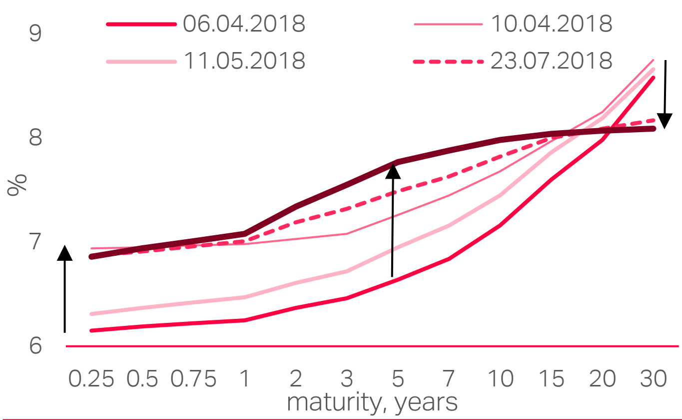
The key point is that this substantial outflow was cushioned by a strong local bid. Thanks to the ample liquidity in the domestic financial system, Much of this demand came mainly from the large Russian banks attracted by the yield uptick – and with added 'encouragement' from regulatory requirements on short-term liquidity ratios. This regulatory stimulus will intensify as this ratio will rise next year from 90% to 100%. Another important component of the local bid was non-state pension funds, which increased their exposure to the OFZ market in H1/18 by 25% yoy to Rb880 billion – maintaining similarly strong growth begun last year (the background to this important move is discussed under 'Exhibit 5' below).

Non-resident holdings of OFZs



Source: CBR

OFZ zero coupon yield curve



Source: MOEX

The OFZ market comfortably passed this stress test in Q2/18. The dark line in the benchmark yield curve (right-hand chart above) highlights both the stress itself and the cushioning. While the whole curve has moved up (left arrow) and the yields in the belly are now higher than after the April sanctions shock (middle arrow, reflecting also the increasing volume of primary issuance at these middling durations), the long end (right arrow) has tightened even below the pre-sanctions level.

At the time of writing, that episode is playing out again in a new bout of turbulence. Our sanguine outlook – based on this financial deepening driver – is set out in the final 'Investment Conclusion' section of this report.

Savings flow into the domestic capital market

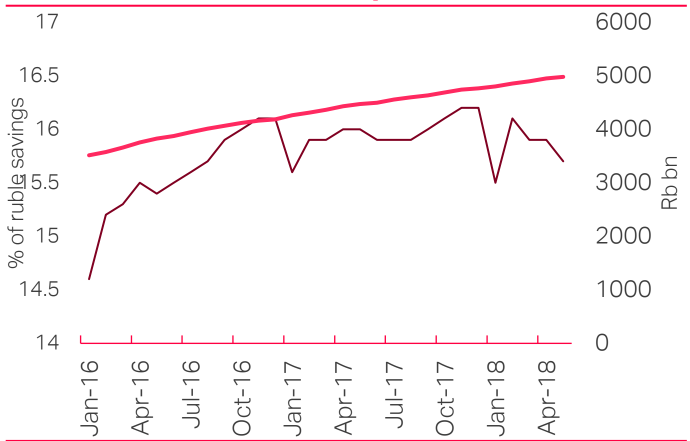
Exhibit #2: Bonds appeal to individuals – and equities to follow

We now move on from a case history to look at a more structural source of deepening that concerns specifically the debt capital market. Like any case history, the recent episode in the OFZ market provides indications – positive in this case – rather than some kind of proof. A variety of factors were in play in that stress test – some structural (like the operation of the fiscal rule and bank regulation), others more to do with the conjuncture (such as the helpful coincidence of the widening current account surplus thanks to the high oil price). By contrast, the CBR's steady easing of its monetary stance in line with progress towards stabilizing inflation at the 4% target is driving more retail savings from bank deposits to higher-yielding bonds.

While the yield-pick from corporate bonds is the main draw, some additional factors are at work.

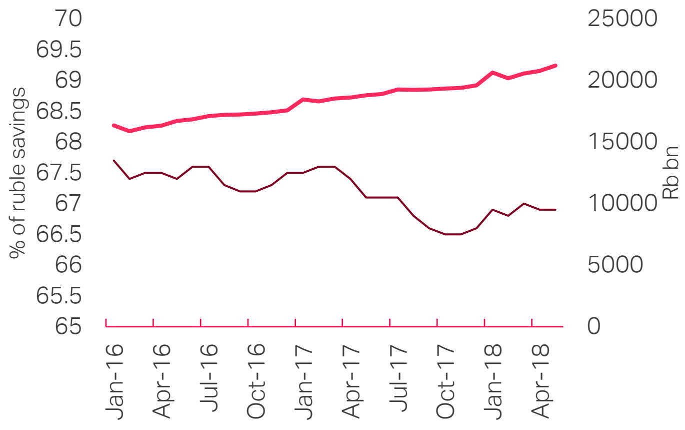
- Since 2016 the Moscow Exchange (MOEX) has developed a friendly and **efficient offering for retail investors**, whether trading on their own account of through brokers/asset managers. Individual accounts have been growing at double-digit annual percentage rates since 2016 (we looked at this in more detail in a note last November). The most readily measurable segment of this retail investing scene is local fund managers' individual client accounts. By the end of last year, total funds held in such accounts amounted to Rb1.3 trillion – which is over a fifth of Russia's (for now very modest) total pension assets.
- Since the start of this year, the **tax treatment** of coupon pay-outs on bonds has become the same as bank deposit interest – that is, likewise exempt from income tax. Further tax breaks for retail investors are in the pipeline, such as a similar exemption for paper FX gains. Up to Rb1 million may now be placed in fully tax deductible individual investment accounts, which bodes well for an increase in the modest aggregate sum in such accounts of Rb52 billion recorded at the end of 2017 (representing a 150% yoy gain).
- To return to the **price incentive**, this will have seemed particularly powerful this year to retail savers with maturing deposits placed in 2015 when nominal rates were double their present levels. Although there is no more recent aggregate data on retail brokerage and managed accounts than end-2017, MOEX reported a sharp rise in the retail share of primary demand for bonds in Q2 – from around 3% to 6.7%. As corporate bond yields decline, the price incentive will push more retail funds into the better yielding equities (which right now means natural resource exporters).

Households' securities portfolio



Source: RosStat

Household deposits



Source: RosStat

The steady rise in individual holdings of securities is shown in the left-hand chart above. The chart also shows that the jump in the share of bonds and other securities in total private savings has levelled off in the past year; but this reflects not a change in the trend but the relative effect of compound interest on the much larger mass of retail bank deposits (right-hand chart).

Exhibit #3: Mobilization of Federal Treasury balances

Switching the focus from private individuals to public savings brings to this story serious scale and additionality. The CBR's First Deputy Governor Ksenia Yudaeva was worrying out loud last month about the attraction of bonds for retail savers squeezing banks' retail funding. In other words, this trend deepens the domestic capital market – which is positive for financial investors in Russia – but is more zero sum as far as overall financial deepening is concerned (hence the concerns of the CBR, which is responsible for financial stability). This problem does not apply, however, to the mobilization of hitherto 'idle' public savings in the form of undisbursed tax revenue and social security contributions.

A first step is broadening access to Treasury funds. Until now, the Treasury has deposited some of its cash only in the largest banks and only for short durations (maximum six months). The scope and scale of the Treasury's involvement in the financial system is now being materially increased. Already since mid-July, the eligibility criteria for banks to bid for Treasury deposits have been relaxed, increasing the 'pool' of banks from seven to thirty-five.

A more fundamental reform will follow by the end of the year. Instead of auctioning unsecured deposits to select banks, Treasury funds will be available through a central counterparty (MOEX) against collateral at market pricing. In contrast to the CBR's expensive – hence rarely used – repo window where OFZs are virtually the only collateral used, this Treasury facility will allow a much wider range of collateral. Above all, the Treasury can supplement CBR facilities with substantial volumes. Speaking in early July, the head of the Treasury, Roman Artyukhin, said Treasury funds now placed on bank deposits amounted to barely more than 10% of the large total cash balances of Rb4.3 trillion which the Treasury manages. This expansion in the volume of available repo funding should facilitate further deepening of the domestic capital market. The reform is timely, as the government's plans to increase annual net OFZ issuance by over Rb500 billion to fund new infrastructure projects might otherwise crowd out private sector borrowers.

Exhibit #4: De-dollarization gathers pace

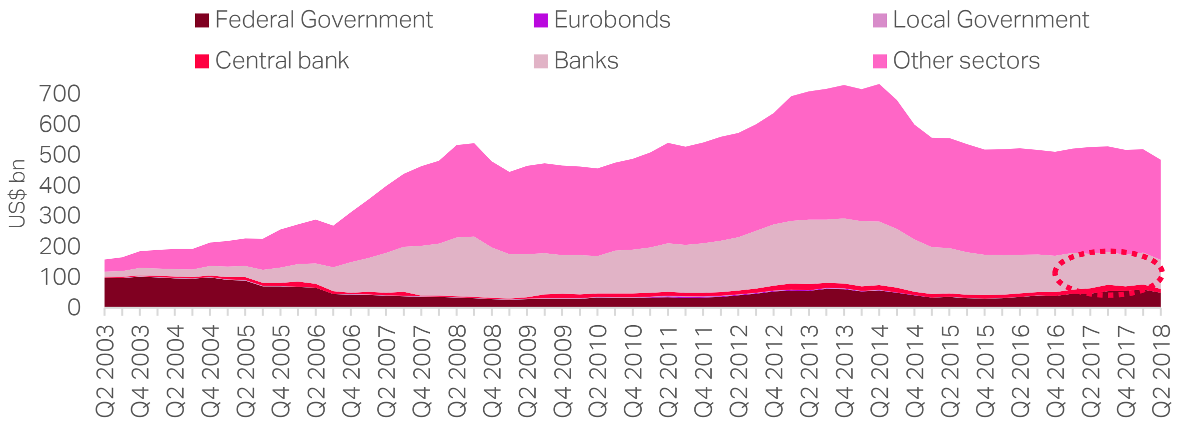
Here is an area where growing local currency savings underpinning domestic markets are a side-effect of strategic policy goals. The de-dollarization of the financial system and reversal of capital flight are necessary conditions for financing productivity-enhancing investment and, by reducing vulnerability to external shocks, raising the propensity to save in rubles and invest domestically in the first place – as opposed to saving in foreign currency and investing abroad.

The first aspect of this policy push is a further instance of the more effective use of public savings: FX swaps using Finance Ministry funds. The FX market interventions under the fiscal rule are designed to reduce the volatility of the exchange rate in response to oil price movements: but periodic volatility bouts will still occur, if only as a result of tax settlement deadlines and seasonal capital flow patterns (such as summer holidaymakers' demand for foreign exchange) – even without non-oil related external shocks like last April's US sanctions hit and this month's new sanctions scare. To counter such volatility, the Finance Ministry plans in Q4/18 to give the financial sector access to the FX-liquidity accumulated through the fiscal rule interventions by testing FX-swaps on the MOEX.

This new FX swap facility offered by the Finance Ministry will complement and improve on the CBR's equivalent window. These benefits will be achieved by adding volume and duration. Back in the late-2014 currency crisis, the CBR's FX repo and swap facilities calmed nerves about high external debt repayments and associated fears of capital controls. It would have been much better to have avoided any panic in the first place. Beefing up the FX liquidity backstop in this way will help insure against this. It should also make a systematic contribution unrelated to crisis episodes by creating cheap FX-hedges with a wide range of maturities (in contrast to the present maximum 28-day duration of the CBR's FX repo facility). The Treasury can deploy sufficiently large volumes to create a whole new hedging market. This goal has been set back in the past two years by Transneft's eye-catching litigation against Sberbank over losses from a FX derivative contract. A safe and liquid FX derivatives market will support the cause of financial deepening by reducing the need for precautionary FX savings – or, put another way, help economic agents learn to live with the floating exchange rate. The existing FX swaps offered by the CBR are not suitable for hedging purposes: they are mainly a money market instrument, with almost all volumes concentrated in the overnight segment with substantial OTC trading (as in the NDF market) and sometimes opaque pricing.

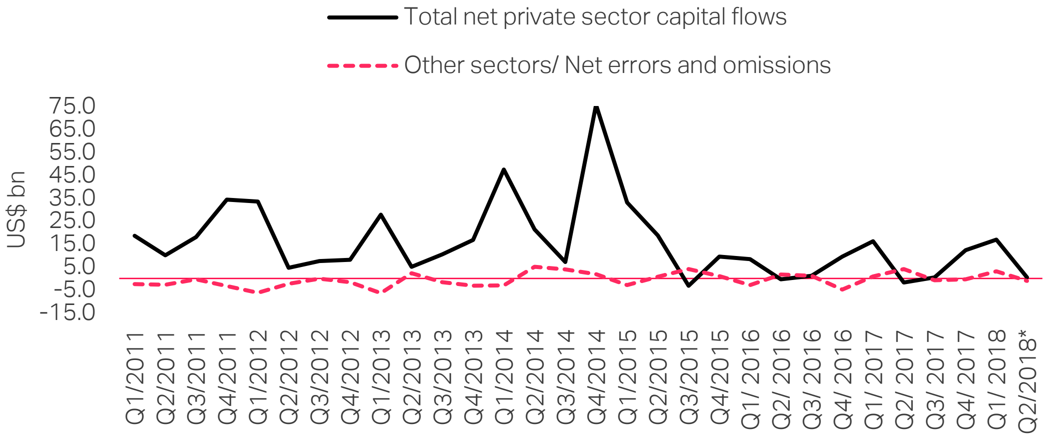
Financial deepening is also a side effect of the CBR's drive to reduce the FX-denominated share of Russian banks' balance sheets for financial stability purposes. The latest quarterly BoP numbers – for Q2/18 – show total external debt falling to US$486 billion – below the level of official international reserves for the first time since the 2008 financial crisis. The main driver – highlighted in the chart below – is the decline in Russian banks' external liabilities (the bulk of which are deposits), which have fallen to their lowest level since Q3 2006. To reinforce this trend, the CBR at the start of this month hiked required reserves on FX liabilities by 1ppt (to 7% for individual deposits and 8% for corporate deposits). This measure followed a similar move on the asset side in force since 1 July, increasing risk weightings on FX-denominated loans. For the first time with such a measure, this includes borrowers which are exporters with FX revenues (the weighting here rises from 100% to 110%).

External debt breakdown



Source: CBR

Capital flows: coming home

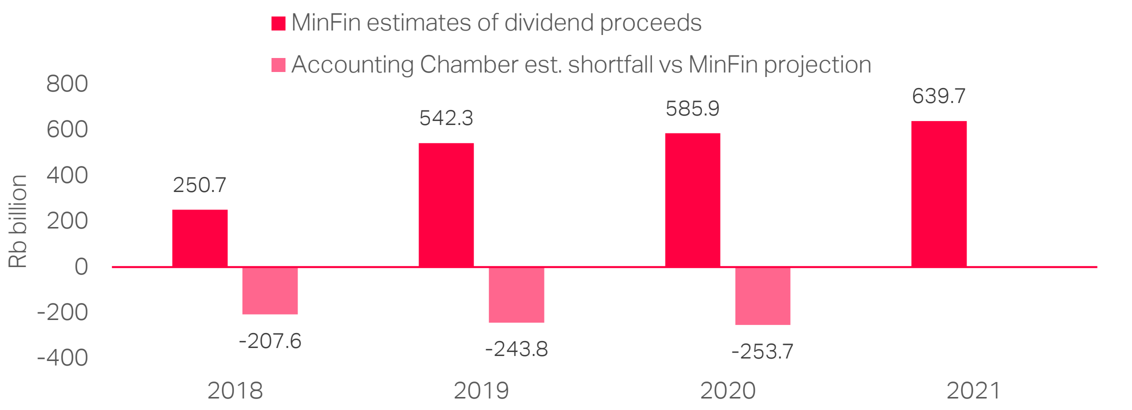


Source: CBR

The strategic goal is to reverse capital flight, thereby expanding domestic (ruble) savings for investment. Another highlight of the Q2 BoP data was the virtual disappearance of net private capital outflows (chart above). As the chart also shows, this is bound to be a choppy process. Over and above regular seasonality, external deleveraging will have the short-run effect of increasing outflows (in the form of principal debt repayments). On a longer term horizon, this agenda hinges on overall risk perceptions. Here, the policy drivers extend well beyond the monetary and fiscal basics that, as we have seen, support initial financial deepening progress. Other key conditions include improved property rights together with better regulation and less predatory enforcement. Yet the 'basics' should never be underestimated.

A good illustration of the importance of policy 'basics' – for better or worse – is provided by the topical scare over proposed new windfall taxation of non-oil extractive sectors. We predict that this dubious initiative, which comes from President Putin's economic policy aide Andrey Belousov, will be kicked into the long grass by the government. If any such measure were ever implemented, however, this would be the perfect invitation to increased capital flight. The cause of financial deepening – and raising economic growth potential – depends on business owners (and minority shareholders) being inclined to put as much as possible of their dividend proceeds to work in the domestic economy, including through the banks and capital markets.

SOE dividend forecasts



Source: Finance Ministry, Accounting Chamber

While Russia's (winning or losing) response to this challenge plays out over years, to be going along with there is the bankable gain of the government forcing SOEs to pay higher dividends. As shown in the chart above, there remains plenty of room for further progress. As things stand, the government's share of over half of these dividends comes from exporters (mainly Gazprom and Rosneft): so this improving trend amounts to capital repatriation that does not even depend on the investment climate.

Exhibit #5: Pension revolution

The new investment pillar of the pension system

Our final exhibit is the jewel in the crown of this financial deepening story – only, for now, a virtual one. It is also a major upcoming test, since the enabling legislation for the long-planned new pension investment system based on employee contributions is supposed to be enacted this coming winter. That done, the system itself would be up and running from 2020. Any slippage would signify a failure of political will to go through with this vital reform, and all bets on its final form and timing would be off.

In our financial deepening perspective, the prize of this reform being successfully implemented is huge. The plan is to roll-out the scheme gradually with employees saving at the outset 1% of their salaries in "individual pension capital" pots that will be managed by private ("non-state") pension funds, and adding another percentage point in each of the five years following the launch to reach the targeted 6% of salaries. The designers of the scheme (Central Bank and government economic policymakers) estimate that once that target has been reached, the result will be long-term savings equivalent to 0.5% of GDP flowing every year into the domestic capital market. In current rubles, that annual increment is equivalent to around 10% of existing *total* pension assets.

Strong validation

A recent CBR-commissioned study strikingly validates the potential contribution of this pension investment reform to economic growth goals. The study conducted earlier this year by researchers from the Macroeconomic Analysis Centre (a Moscow think tank) led by Mikhail Mamonov looks at financial deepening in the round. It measures the economic benefits of progress in six different areas of financial deepening: domestic bank credit, local currency corporate bonds, external debt, equity market capitalization, private pension assets and insurance assets.

The study models the benefits of reaching an optimal deepening frontier. The model identifies in each of these six cases an optimal level of deepening beyond which any further improvement would cease to have net positive effects. In the case of private pension assets, the optimum level is found to be 52% of GDP compared to today's 4% (which the study forecasts to rise no higher than 10% by 2035 – in other words, reaching that optimal frontier will take decades). The study shows the varying benefits generated by each type of deepening progressing from its present state to the defined optimal level. The benefits are quantified as units of an overall "utility function" that aggregates four components: GDP growth, the volatility of that growth, CPI change, and the duration of episodes of financial distress.

The study's findings summarized in the table below show the expansion of pension assets as by far the most beneficial form of financial deepening. For ease of reading, we have superimposed on the scores (which are abstract utility function units) a standard heat map colour scheme to highlight the relative findings at a glance. Reflecting the inherent utility of financial deepening, all the scores in the "overall benefit" column are positive. One notable finding is the relatively mixed results – i.e. drawbacks – of expanding bank credit. The clear highlight, however, is the clean sweep of dark green in the 'pension assets' line. As far as boosting sustainable growth is concerned, no other channel of financial deepening comes anywhere near the effect of building a vibrant pension investment system. This amounts to a conclusive rationale for the planned pension investments reform.

Comparative benefits of forms of financial deepening in Russia

Pension assets are the financial deepening champions

			Utility function sub-components			
Deepening channel	**Overall benefit (+)**	**Elasticity* (%) (+)**	**GDP change (+)**	**Vol. of GDP change (-)**	**CPI change (-)**	**Financial instability (-)**
Domestic credit	0.11	0.4	0.3	-1	0.2	2.5
Local corp bonds	0.46	2.1	1.4	-0.2	-3.7	-8
External borrowing	0.24	2.1	1	-0.7	-1.1	0.6
Equity market cap	0.47	0.7	-0.5	1.2	-3.4	-38
Pension assets	2.57	5.4	4.1	-5.6	-6.7	-86
Insurance assets	1.45	13.4	1.9	-2.7	1.7	-76

Source: TsMAKP, CBR.
**'Elasticity' means the benefit – "utility function effect" – per each ppt of GDP of deepening*
The +/- signs against each indicator indicate that the higher/lower the score, the better

Life insurance kicker

It is worth noting in passing the potential of insurance – as the 'runner-up' in this CBR study. While the growth of pension assets waits on the implementation of the pension investment reform, the insurance sector is already enjoying rapid expansion. This is all the more notable given that insurance assets post the highest score for 'elasticity' – i.e. the immediate benefits of growth (even if pension investments yield considerably larger overall benefits once the deepening frontier is reached).

The life insurance segment is the one to watch. Although the CBR study takes account of all kinds of insurance rather than just life products, life insurance is the most relevant to our theme, since life premiums should generate much the largest flows of long-term investment in the domestic capital market. In any case, CBR data for 2017 show life premiums growing much faster than other products – by 9.8% yoy in 2017 after 8.3% the previous year. This growth is coming off a low base, with total premiums amounting to only Rb330 billiion last year (just 0.36% of GDP). Even at these modest levels, life premiums are set to make some immediate impact on the capital market to judge by a CBR consultation paper published this month that proposes removing an existing ban on investing insurance assets in corporate and municipal bonds (while placing tighter limits on less liquid real estate exposures).

Four reasons why this pension reform will happen

1. A key to growth goals

The reform is a necessary condition for achieving Putin's core economic goals. The main reason why we think the pension investment reform will happen is that economic policymakers understand the prize – as now convincingly quantified by this study for the CBR – and will be determined to grasp it. Put simply, the 0.5% GDP of incremental savings that will be mobilized by this reform – in effect, a shift from household disposable income to investment – is one of the necessary conditions for achieving the investment-led growth goals set by Putin for his new six-year term. This reality is reflected in the frequently and publicly reaffirmed commitment to the reform on the part of key policymakers – notably CBR Governor Nabiullina, Sergey Shvetsov (her deputy responsible for financial market regulation) and Deputy Finance Minister Alexey Moiseev.

At the same time, the reform has until now been strongly resisted by some other policymakers – mainly in the government's social policy 'bloc'. The political will to make this reform happen might also be weakened by the social reaction to the increase in the pension age (unlike the pension investment plan, this 'other' pension reform is already underway in the sense that the enabling legislation has begun its parliamentary stages). Our remaining reasons for expecting a positive result hinge on the strategy of the reform's instigators to satisfy objectors and prevail over opponents.

2. Flexible response to objections

Debates among policymakers have resulted in the original 'opt-out' design changing to 'opt-in', but this practical effect of this change should prove marginal. The initial idea had been that all employed persons would be automatically enrolled in the new individual pension investment scheme unless they took the trouble to opt out (a choice that would, the designers reckoned, be deterred in most cases by ensuring sufficient administrative 'trouble'). The 'social bloc' objected that all individual pension investments should be voluntary. The reform's proponents ended up conceding this point on the legal grounds that their scheme would have required impractically problematic amendments to the Civil Code. Meanwhile the social bloc – now, incidentally led by a Finance Ministry veteran, Tatyana Golikova – has swung behind the reform as offering tactical cover for its separate agenda of improving the transparency of the 'pay-as-you-go' component of pension incomes.

The definitive plan incorporates incentives to maximize voluntary participation in the scheme. Since these pension savings will feel to most people – who have scant trust, understanding and expectations as regards pension investments – as an additional income tax, the 'blow' will be softened by making at least part of payments into individual pension pots deductible from people's income tax base. Employers will receive separate tax incentives for co-funding and/or supplementing individual employees' pension savings. Perhaps more important than such formal incentives, the culture and practical realities of the typical Russian workplace – characterised by employers' strong powers of suasion - should suffice to ensure that substantial majorities of employees sign up for the new scheme.

3. The pension industry being made fit for purpose

The CBR has faced a serious challenge in ensuring that pension fund managers can be trusted with the public's money. The background here is the present investment pillar of the state pension system, based on employer-contributions into employees' individual pension savings pots. Launched in 2001, this system has been suspended since 2014 and will be formally replaced by the planned new arrangements based on employee contributions.

Officials in the government's social policy 'bloc' have never liked this investment pillar. They would prefer the whole state pension system to be 'pay-as-you-go'. Their main argument has been the poor (often negative) real returns on these invested pension contributions, whether managed by the State Pension Fund (accounting for 40% of the total of Rb4.38 trillion of such funds in 2017) or the private managers responsible for the remainder. For more than the first decade of this system, the managers had the respectable 'excuse' that real interest rates were often negative. Since the CBR shifted to orthodox inflation targeting in 2014, that excuse fell away – to reveal the 'naked swimmers' of incompetent and/or corrupt pension managers. The following year, the CBR launched a clean-up of the sector. To remain in operation, all these fund managers would now have to be part of a new compensation fund (analogous to deposit insurance in the banking sector), and their eligibility for this fund was subject to financial scrutiny – while the transparent JSC form of legal organization also became compulsory.

2017 results of Otkrytie-affiliated pension fund managers

These managers account for 40% of privately managed mandatory pension pots

Fund manager	Pension AUM (Rb bn)	Individual retirees (thousands)	Net yield (%)	Losses (Rb bn)
Lukoil Garant	253.2	3499	-5.26	47
RGS	182.6	3155	-2.86	5
Electricity Gen	92.6	1057	-1.7	17
Safmar	192.3	2266	2.98*	-
Budushchee	282.6	4428	-2.01	6

*Source: CBR. (*Safmar's small positive return will be wiped out by absorbing losses from writing down Otkrytie Holding bonds with a face value of Rb13.7bn)*

2017 saw the worst ever scandal to hit the sector. This came despite the clean-up operation having been largely completed – with only 66 pension managers now approved by the CBR compared to the 102 in operation in 2016. The failure of three important privately-owned banks (Otkrytie, Binbank and Promsvyazbank) resulted in serious losses for some large pension fund managers affiliated with the Otkrytie group. These managers – shown in the table above – accounted last year for 40% of all pension investments entrusted by individual future retirees to such private groups. It turned out that these managers had ploughed up to a fifth of their assets into securities issued, collateralized or guaranteed by related parties and/or the owners and affiliates of those failed banks.

On the face of it, this scandal is a major blow to the credibility of the new pension reform: but the CBR, which has supervisory responsibility, has come out fighting. It has made all the funds whole (with one exception – see the footnote in the above table). So the future retirees concerned will not suffer any capital losses (although they foregoing any returns for the year). While highlighting the difficulty of proving criminal wrongdoing behind those dubious investment, CBR Governor Nabiullina insisted in a press interview in June that all private pension managers will be subject to ever tighter regulation and unremitting scrutiny. The CBR stress tests have already forced these funds to improve the risk profile of their portfolios. In the case of Lukoil Garant, for example, the share of OFZs in the portfolio has risen to a third – more than twice last year's level. Another topical illustration is last month's large Rb40 billion domestic bond issue by Gazprom, which has been forced to tap the local market for refinancing since losing access to international DCMs pending settlement of a legal dispute with Ukraine. Domestic private pension managers took up 80% of that bumper Gazprom ruble bond issue.

4. Fiscal and longer-term political risks

Policymakers must find ways of cushioning the inexorable decline of retirement incomes generated by the 'pay-as-you-go' part of the pension system relative to wages. Owing to pre-election give-aways, the ratio of average pensions to salaries fell from 33.7% in 2017 to 29.1% by the middle of this year. The recently announced increase in the pension age – that will take gradual effect through to the mid-2020s – is designed to relieve the fiscal strains from the rapid expansion of pensioners relative to the working-age population. Looking further into the future, the top-up retirement incomes coming from returns on the proposed new individual pension investment pots will be increasingly important for maintaining minimal acceptable living standards for that growing number of pensioners – and on this, in turn, depends overall macroeconomic, social and ultimately political stability.

Investment conclusion

Our theme justifies increased allocations to Russia – in the long term. For all the progress that Russia has already made with financial deepening and the prospect of a further breakthrough with the planned new pension investment system, it may still seem a stretch to recommend structurally increased Russia weightings in EM portfolios on the strength of this long-term story. At a time when Russian financial assets and the ruble are being buffeted once more by (prospective and actual) new sanctions, this theme will more likely be viewed as 'deep background' – something to be born in mind as and when better times come to Russian markets.

While live geopolitical risks may swamp a long-term theme like financial deepening, such risks also – and paradoxically – boost this positive underlying driver. The sanctions environment facilitates capital flight reversal and incentivizes the government to reinforce this capital repatriation trend – and also mobilize domestic savings to finance the higher FAI that is indispensable for growth. These amount to various tributary streams of the overall flow of financial deepening: but note how the main benefit for portfolio investors' risk adjusted returns – that is, a deeper and more liquid domestic capital market – is all the more credible for being an incidental side-effect of these strategic goals.

The beauty of side effects – especially on corporate governance

Such incidental benefits for international investors in EM are often more credible than conscious investor-friendly policies. An investment case based on an EM government's benevolence towards portfolio investors will always be hazardous: for, however sincere, that benevolence must usually be traded off against other priorities. When, however, the benefits for financial investors are spin-offs from a country's paramount goals and interests, investors can and should position themselves with all the more confidence to benefit from those incidental effects.

A perfect example of such an effect linked to our financial deepening theme is corporate governance. The local equity market will be an important destination for a substantial portion of the incremental domestic fund flows generated by the pension investment reform – providing at long last the ballast of a solid domestic institutional investor base. While the final regulations may allow some investment of those funds in foreign securities, the permitted quota is likely to be well short of the flexibility recommended by the IMF and World Bank. In other words, maximizing future retiree incomes will be traded off against a national investment bias in support of the strategic economic goal of promoting investment-led growth.

At the same time, with the mass public increasingly exposed to domestic equities through the new pension investment scheme, the authorities will have a powerful political incentive to protect this domestic investor base from losses caused by corporate governance abuse. The government's existing incentive to enforce proper dividend discipline in SOEs will also be strengthened. These incentives are not theoretical. They have already been seen in action back in 2012, when Putin mandated a premium buy-out of local retail investors' shareholdings acquired in the 2007 "people's IPOs" of VTB and subsequently devalued as a result of the global financial crisis.

From long term to short term

Financial deepening is also creating opportunities in the here and now. We add an important topical rider to our core conclusion that financial deepening will be something for investors to 'enjoy' once the present geopolitical risk premium and other headwinds have abated – and, of course, after the Russian government has successfully launched the pension investment reform by enacting the required enabling legislation next winter. The same turbulent conditions that postpone the full benefits of financial deepening also allows the progress already made in this area to make itself felt right now. Our first 'Exhibit' in this note highlighted the importance of the structurally stronger local bid for the OFZ market recovery from last April's sanctions shock. At the time of writing, only a week has passed since the latest bout of sanctions-related Russian market turmoil. Signs of stabilization are already apparent, and, once again, a prompt recovery is to be expected. These live episodes show financial deepening in action.

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